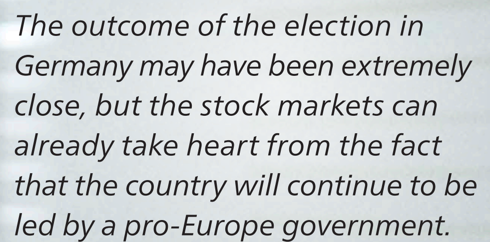


The outcome of the election in Germany may have been extremely close, but the stock markets can already take heart from the fact that the country will continue to be led by a pro-Europe government.

Michael Herzum, Head of Macro & Strategy

Market news and expert views

Monthly report
October 2021

We work for your investment

Union Investment

The markets at a glance

Summary

In recent weeks, there has been little change in the fundamental matters affecting the capital markets. The global economy remains in a phase of decelerating growth. Low prices in the prior-year period and strong demand are keeping inflation at a high level, which is painting an overblown picture of the underlying price trend. There has been no let-up in the debate about the scaling back of bond purchases (tapering) by the US Federal Reserve (Fed), even after the latest central bank meeting. Besides weak growth and tighter regulation in many economic sectors, China now faces the additional problem of the crisis-stricken property developer Evergrande.

For now, these factors are still holding back market growth and preventing us from adopting a more bullish stance. We believe that they represent only temporary difficulties for the markets, however. The economic cycle is essentially returning to normal and remains intact. The rate of inflation is expected to decline markedly again next year. If Evergrande were to enter insolvency, there would probably be little contagion or spillover effects. Although the Chinese property market is likely to cool, resulting in slower growth for the world's second largest economy, we do not anticipate any systemic risk or a 'Lehman moment'. Moreover, the spread of the delta variant of coronavirus is currently slowing slightly. The latest infection data indicates that case numbers may now have peaked in some regions. Consequently, the environment for risk assets remains favourable in the medium term. We therefore confirmed our neutral risk positioning (RoRo meter at level 3) once again.

Economy, growth, inflation

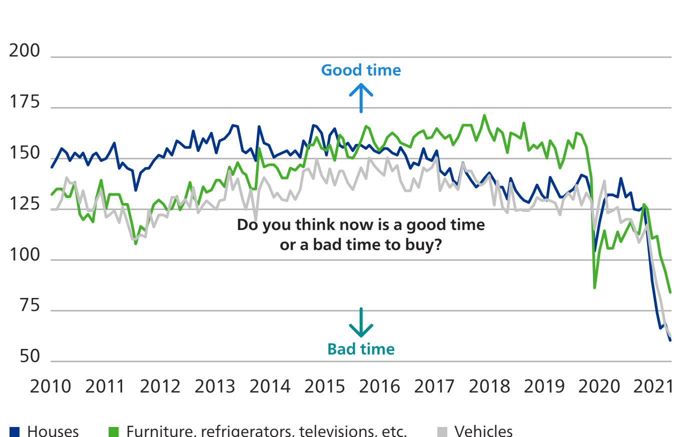
Global economic growth has continued to slow down in recent weeks, which was reflected in a variety of indicators. Several factors are making consumers more reluctant to spend as well as creating additional problems for manufacturers. These factors include the spread of the delta variant of coronavirus, the persistent supply chain problems and a number of natural disasters (hurricanes, forest fires, flooding). Our economists have now updated their economic projections for 2021 as a whole and have slightly raised the forecast for the eurozone from 5.1 per cent to 5.3 per cent following a strong second quarter. The economic growth forecasts for the US and China, meanwhile, have been lowered from 6.7 per cent to 6.0 per cent and from 8.9 per cent to 8.2 per cent respectively. This outlook for China is attributable, firstly, to weaker US consumer spending in the current quarter and, secondly, to Beijing's zero COVID policy and increased regulatory intervention in the economy. But this does not mean that the global upturn has come to an end, rather that it is normalising in line with the economic cycle. For 2022, our economists now predict growth of 4.8 per cent in the eurozone, 4.3 per cent in the US and 5.0 per cent in China.

The estimates for inflation have also been adjusted. Although we have raised our forecasts slightly, we continue to believe that the current rise in inflation is painting an overblown picture of the underlying trend. Inflation expectations have not shifted and wage demands are moderate, especially in Europe. Consequently, the rate of inflation is expected to decline markedly again as early as 2022. Specifically, we anticipate price rises of 2.3 per cent for 2021 and 1.7 per cent for 2022 in the eurozone and 4.2 per cent for 2021 and 2.6 per cent for 2022 in the US.

Economic data has proved disappointing of late
Index UBS Global Growth Surprise index

Sources: Bloomberg, UBS, as at 22 September 2021.

High prices are weighing on US consumer sentiment
The University of Michigan's index at a long-term low



Sources: Bloomberg, University of Michigan. as at 23 September 2021.

The markets at a glance

Monetary policy: Fed firms up its tapering plans

The central banks are seeking a path back to normality even if many are still a long way from making their first interest-rate hike. At its latest meeting, the Fed sent a very clear signal that tapering of its bond purchases would begin soon. Fed Chair Jerome Powell said at the press conference that the reduction may even begin before the end of this year. This means the purchases could conceivably be brought to a complete halt as early as mid-2022. However, he stressed that specific dates had not yet been set. These unexpectedly bullish words indicate that the Fed wishes, as soon as possible, to at least have the option of making a first move on interest rates after the end of tapering, should a more persistent rise in inflation make this necessary. The Fed's new macroeconomic projections continue to paint a constructive growth picture, even though the projection for economic growth in 2021 has been lowered substantially from 7.0 percent to 5.9 percent. The Fed also published its dot plot, which indicates that half of the Fed members anticipate the first interest-rate rise by the end of 2022 and the other half not until 2023. Following the latest meeting, we believe that tapering will be announced at the meeting in early November and will begin immediately afterwards. We do not expect to see the first rise in interest rates before 2023.

The European Central Bank (ECB) also appears unfazed by the current high rate of inflation and is maintaining its course. Although it is likely to announce the end of the pandemic emergency purchase programme (PEPP) in December, its purchases in the 'normal' asset purchase programme are continuing and may even be increased to soften the blow of stopping PEPP. Interest-rate hikes in the eurozone are not expected until 2025 at the earliest.

Fixed income: opportunities hard to come by

The big question for the bond markets is still whether the surge in inflation since the beginning of the year represents a temporary phenomenon or the start of a sustained period of price increases. The latest economic data is presenting a mixed picture in terms of answers to this question. Overall, the current high level of inflation is likely to recede over the coming months, mainly because the effect of low prior-year prices will begin to fall away. Despite the recent decline in yields on safe-haven bonds, we believe that the factors likely to trigger a modest rise in yields over the coming months (healthy growth, elevated levels of inflation, tapering talk from the Fed) remain intact. Our year-end yield forecast for ten-year Bunds stands at minus 0.2 per cent, while the projected increase in yields on US Treasuries of the same maturity is a little higher at around 1.6 per cent.

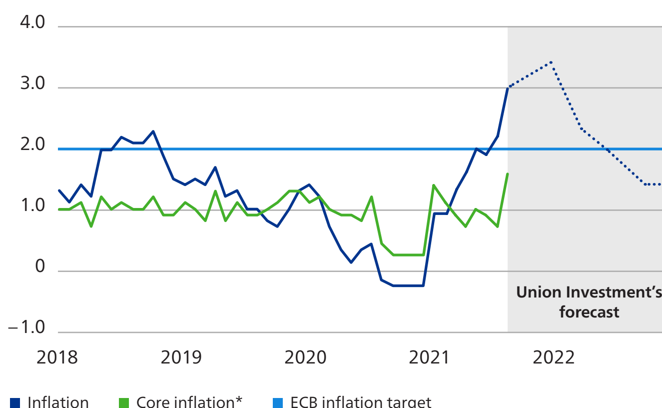
Spreads in the more opportunity-oriented segments of the bond market are still low despite having widened slightly due to the events surrounding Evergrande. Opportunities are therefore hard to come by. Bonds from the emerging markets may be in demand because of their higher yields, but the situation in China and the prospect of rising US yields suggest it would be unwise to take a position right now.

- **Change:** None.
- **Positioning:** We are avoiding government bonds from core eurozone countries and the US as we are expecting something of a headwind from rising yields. Our position in all other bond segments is neutral.

Powell speech rekindles hopes of interest-rate rises
Implied key interest rate based on Fed Funds Futures (%)

Source: Bloomberg, as at 23 September 2021.

Upward distortion of inflation due to low prices in prior year – situation set to ease in 2022
Consumer price indices, year-on-year change (%)



* Excluding food and energy prices.
Sources: Bloomberg, Refinitiv, Union Investment, as at 21 September 2021.

The markets at a glance

Equity: preference is still for stocks from the industrialised countries

Despite numerous sources of downside risk (weakening global growth, high inflation – albeit temporary – caused by low prior-year prices and strong demand, and the Fed's impending tapering announcement), equities remain supported by the high level of liquidity and by investors on the hunt for returns. The equity markets suffered a modest setback as the crisis enveloping Chinese property developer Evergrande deepened, and its positioning and valuation have been adjusted as a result. Revenue and profit expectations for the upcoming corporate reporting season for the third quarter are high, but should be achievable. Although the number of upward revisions by equity analysts has tailed off due to the weakening of growth, it is still at a high level.

The tightening of regulation in China continued to dominate the trend in equity prices in the emerging markets, and the recent events surrounding Evergrande have also been a major factor. These regulatory measures have been hitting not just the index heavyweights of the emerging markets in the Asian tech sector but also, and most dramatically, Chinese real estate and financial stocks. It is still too early to give the all-clear, especially as the latest moves by Beijing will deter many market players from investing for some time to come. Equities from China and, as a result, from the emerging markets are generally expected to see a higher markdown. In the short term, however, there may be tactical opportunities to benefit from a recovery.

- **Change:** None.
- **Positioning:** Our assessment of equities is neutral overall. More specifically, however, we prefer industrialised countries over the emerging markets when it comes to stocks.

Commodities: slowing growth weighs on metals

The slowdown in economic growth at global level, and especially in China, is continuing to weigh on the prices of industrial and precious metals. The precious metals platinum and palladium, which are used in automotive manufacturing, were particularly hard hit as some major carmakers announced that they would be cutting production. This is because a number of models cannot be manufactured as planned due to the global shortage of microchips. The technical picture for many metals, including copper, has now also deteriorated because of these falling prices. Iron ore had already fallen victim to this trend some time ago, seeing the gains it had made between November 2020 and the beginning of May, when it doubled in price, completely wiped out.

The energy segment, however, has now very much decoupled from this trend, with prices surging in recent weeks. Excess demand in the oil market ratcheted up further following the production outages in the Gulf of Mexico caused by Hurricane Ida. Although the OPEC+ members and US shale oil companies are gradually ramping up production, supply and demand are only very slowly moving back into equilibrium. Supply remains tight in the market for natural gas too, particularly in Europe, where inventories are well below the long-term average. A cold winter could lead to shortages of supply.

- **Change:** None.
- **Positioning:** Our stance on commodities is neutral both overall and at the level of individual sectors.

EM equities recently under pressure

Price/earnings ratio based on expected profits

Source: Bloomberg, as at 17 September 2021.

Gas price has surged in recent months

€ per barrel (Brent) / per MWh (natural gas)

Sources: Bloomberg, Union Investment, as at 21 September 2021.

The markets at a glance

Currencies: profits realised on the US dollar

The debate surrounding a reduction of bond purchases by the Fed remains one of the central drivers for the US dollar. As the Fed is several months ahead of the ECB in these discussions, the US dollar continues to be supported against the euro. During the recent correction in the risk markets, however, the dollar did not demonstrate its usual qualities as a safe haven. Several forks in the road that could prove detrimental for the greenback will be reached in the coming weeks, particularly in the US. On the Washington agenda, besides the approval of the federal budget for the new fiscal year beginning 1 October, is the question of whether to suspend or increase the debt ceiling, a move that the opposition Republicans have so far baulked at. If no agreement is reached and the stopgap measures also fizzle out, the US government runs the risk of being unable to pay its bills. A last-minute deal like the ones we have seen in the past will probably be struck, but there is a residual risk of talks failing to reach a breakthrough. We therefore decided to close the US dollar position and realise the accumulated profits.

- **Change:** Profits have been taken and the US dollar is now no longer considered attractive.
- **Positioning:** None.

Real estate: European office markets

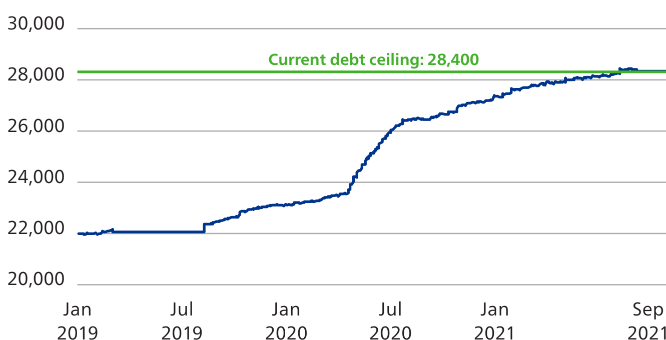
Although the coronavirus pandemic is not yet fully behind us, there are increasing signs that the European office markets have come through the crisis relatively unscathed.

At the end of the second quarter, the average vacancy rate across the twelve biggest European office markets stood at 8.7 per cent. Although this represents a year-on-year rise of around 160 percentage points, the vacancy rate did go up at a much slower rate in the second quarter. The average quarterly increase since April 2020 has been around 50 basis points, but it fell to 15 basis points in the second quarter of 2021. The second quarter of the year was also the first time since the start of the pandemic that vacancy rates in some places began to fall again, for example by 30 basis points in Amsterdam and by 20 basis points in Luxembourg.

Despite the coronavirus crisis, prime rents have been extremely stable in the twelve European office hotspots. Rents fell by only 0.4 per cent year on year and by just 0.3 per cent in the second quarter. Most of the cities saw their rents hold steady. Paris even managed to buck the trend with year-on-year rental price growth of 3.6 per cent. However, rents did drop slightly over the twelve-month period in cities located in countries that had been particularly hard hit by the coronavirus pandemic, such as London, Lisbon, Madrid and Stockholm.

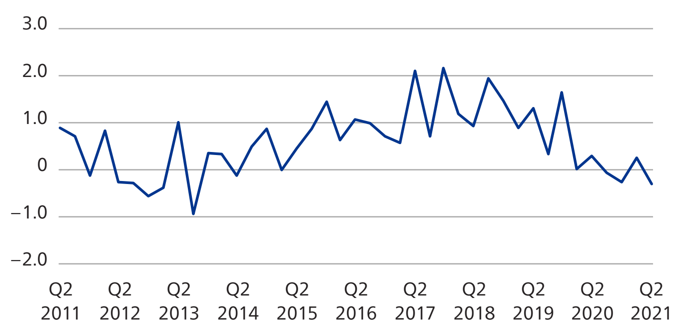
Thanks to falling infection rates over the summer and the fact that vaccination campaigns in European countries are at an advanced stage, lockdowns have been lifted and the economic recovery has begun. This recovery will gain momentum in the second half of the year and the outlook for 2022 is also very positive. As a result, demand for office space is expected to increase significantly in the coming quarters. Vacancy rates in most markets look set to peak at the end of the year. The majority of markets can then expect to see rental prices starting to rise again in 2022.

Urgent need for talks on the US budget and debt ceiling
US debt over time in trillions of US dollars



Source: Bloomberg, as at 21 September 2021.

Quarterly change in prime office rents in Europe
Average (%)*



* Average of the twelve biggest European office markets.
Source: JLL, as at 30 June 2021.

Our assessment at a glance

Our current risk assessment

- We are continuing to observe a slowdown in the rate of growth, higher inflation due to low prices in the prior-year period and strong demand, and stricter regulation in China.
- The crisis at Chinese property developer Evergrande is likely to prove only mildly contagious.
- The Fed could announce a reduction of its bond purchases as early as November.
- Coronavirus infection rates fell again and the situation in regard to the pandemic eased a little.
- Our general risk assessment (RoRo meter) remains at level 3 (neutral).

RoRo meter

Source: Union Investment, as at 23 September 2021. Last changed (from 4 to 3) on 6 July 2021.

Note: The investment strategy is established by first closely analysing the market environment. The result is reflected in a risk rating. For this, the Union Investment Committee (UIC) expresses a risk-on/risk-off decision at one of five levels (1, 2, 3, 4 or 5). It is to be interpreted as follows: a '5' indicates a strong appetite for risk while a '1' indicates a general withdrawal from risk assets.

Our view of the asset classes

- **Fixed income:** There is still much to suggest that yields on safe-haven bonds will rise slightly in the coming months. Spread products now offer hardly any upside potential, but there are opportunities if a selective approach is taken.
- **Equities:** Despite numerous sources of downside risk, equities are being supported by abundant liquidity and by investors on the hunt for return. Events in China mean we will continue to exercise caution when it comes to equities from the emerging markets.
- **Currencies:** The approval of the US budget and the debate over whether to raise the debt ceiling could put pressure on the US dollar.
- **Commodities:** The supply and demand situation in the oil market is easing only slowly in the aftermath of Hurricane Ida. On the other hand, the slowdown in economic growth at global level is weighing on the prices of industrial and precious metals.
- We are maintaining a small **cash** position in the short term but intend to use this liquidity again soon to seize investment opportunities.
- Our assessment of **absolute return strategies** remains positive.
- The outlook for **real estate** has improved a little in Germany but deteriorated slightly in the US.

The → = ← signs indicate the change compared with the UIC's previous decision.

Not favoured | **Neutral** | **Strongly favoured**

Appeal of different asset classes

Asset class	Change
Fixed income	=
Eurozone core government bonds	=
US government bonds	=
Eurozone periphery government bonds	=
Investment-grade euro corporate bonds	=
High-yield euro corporate bonds	=
Emerging market government bonds	=
Equities	=
Industrialised countries	=
Emerging markets	=
Commodities	=
Currencies	
US dollar	←
Pound sterling	=
Japanese yen	=
Emerging market currencies	=
Absolute return	=
Cash	=

Source: Union Investment, as at 23 September 2021.

Note: The table above provides a **relative view of a multi-asset portfolio (excluding real estate)**. If one asset class becomes more strongly favoured, a lower level of investment in another asset class is required in return. The latter would then be classified as less favoured – or vice versa. Real estate is excluded from this analysis.

Real estate	Change
Germany	→
Europe (ex Germany)	=
US	←
Asia-Pacific	=

Source: Union Investment, as at 15 July 2021. Assessment is valid up to 31 December 2021.

Note: The table above provides a **relative view of the office real-estate markets** in light of current market prospects. Due to a lack of more frequently available data, it is only updated every six months.

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READ THE PROSPECTUS BEFORE INVESTING

Unless otherwise stated, all information, descriptions and explanations are dated **28 September 2021**.

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